

Office of Chief Counsel
Internal Revenue Service
memorandum

CC:LM:CTM:SD:TL-N-1647-01
GLGidlund

date: July 7, 2001

to: Victoria Rex, revenue agent
450 Golden Gate Avenue, EG 1236
San Francisco, CA 94102

from: Associate Area Counsel (LMSB), San Diego POD

subject: **Request for Assistance**

Taxpayer: [REDACTED]

EIN: [REDACTED]

This memorandum responds to your request for assistance dated January 24, 2001. This memorandum should not be cited as precedent.

ISSUES:

1. Whether the Service should disallow certain losses and rental expenses claimed by [REDACTED] ("Taxpayer") because the underlying transaction lacks economic substance?
2. Alternatively, whether the Service should disallow certain losses and rental expenses claimed by the Taxpayer because the underlying transaction fails to meet the business purpose test as required by I.R.C. § 351?
3. Alternatively, whether section 482 applies to the Taxpayer and to the other parties to the lease-stripping transaction, and if so, what are the consequences?
4. Whether the Taxpayer is liable for the accuracy-related penalty under section 6662(a)?

CONCLUSIONS:

1. The Service should disallow the losses and rental expenses claimed by the Taxpayer because the underlying transaction lacks economic substance as it was merely one of the last steps in a lease-stripping transaction subject to challenge as contemplated by Notice 95-53.

2. Alternatively, the Service should disallow the losses and rental expenses claimed by the Taxpayer because the underlying transaction fails the business purpose test as required by section 351.
3. Section 482 may be applied to the Taxpayer and to the other parties to the lease-stripping transaction, thus authorizing the Service to disallow the losses and rental expenses claimed by the Taxpayer and to reallocate them to another taxpayer.
4. The Taxpayer is liable for the accuracy-related penalty under section 6662(a).

FACTS:

Our advice is contingent on the accuracy of the information that the Internal Revenue Service has supplied. If any information is uncovered that is inconsistent with the facts recited in this memorandum, you should not rely on this memorandum, and you should seek further advice from this office.

The Service is currently examining the Taxpayer's tax years ended [REDACTED] and [REDACTED]. The periods of limitations for both tax years expire on [REDACTED]. On the U.S. Corporation Income Tax Returns, Forms 1120, for [REDACTED] and [REDACTED], the Taxpayer claimed losses of \$[REDACTED] and \$[REDACTED] respectively. These losses purportedly result from the disposition of interests in a note receivable acquired by a member of the Taxpayer's consolidated group during the tax year ended [REDACTED]. (The period of limitations for [REDACTED] has expired.) The Taxpayer also claimed rental expenses of \$[REDACTED] and \$[REDACTED] for [REDACTED] and [REDACTED] respectively and claimed a net operating loss deduction of \$[REDACTED] for [REDACTED] that was a carryover from [REDACTED] based on a claimed rental expense in that tax year of \$[REDACTED] which in fact represented an earlier disposition of an interest in the above-mentioned note receivable. The Service now proposes to disallow these losses and rental expenses claimed for [REDACTED] and [REDACTED] because (1) the transaction by which the note receivable was acquired and through which the rental expenses were purportedly incurred lacks economic substance, (2) the transaction by which the note receivable was acquired and through which the rental expense for [REDACTED] was purportedly incurred fails to meet the business purpose test of section 351, and (3) section 482 applies to the Taxpayer and to the other parties to the lease-stripping transaction.

In [REDACTED] the Taxpayer, through its subsidiary [REDACTED] was involved in the end stage of an elaborate lease-stripping transaction with regard to the rental of [REDACTED] (collectively "Equipment"). The Taxpayer, a California corporation, was incorporated on [REDACTED]. On that same date, [REDACTED] also a California corporation, was incorporated. Our understanding of the transaction is

derived from the Taxpayer's responses to Information Document Requests ("IDRs") prepared by the assigned revenue agent and from a review of the purportedly dispositive documents evidencing the various steps in the transaction, most particularly the Assignment and Assumption Agreement dated [REDACTED] ("A & A Agreement") (copy attached) between [REDACTED] and [REDACTED], a Nevada general partnership, the [REDACTED]% partner of which is [REDACTED], another partnership whose majority partner is the [REDACTED], a tax-exempt entity. The A & A Agreement evidences one-half of a purported section 351 transfer. Attached to this memorandum is an Excel chart that graphically depicts the various steps in the transaction and two Visio charts with accompanying notes that also depict the steps in the transaction.

Step 1: Prior to [REDACTED] the Equipment had been owned by [REDACTED], a New York corporation, and leased to two unrelated third-party lessees that operated the Equipment for bona fide business purposes. The [REDACTED] had been leased by [REDACTED] since [REDACTED] with the lease term for [REDACTED] of the [REDACTED] and the [REDACTED] expiring on [REDACTED], and with the lease term for the remaining [REDACTED] expiring on [REDACTED]. The [REDACTED] had been leased by [REDACTED] since [REDACTED] with the lease term for the [REDACTED] expiring on [REDACTED], and with the lease term for remaining property leased by [REDACTED] expiring on [REDACTED]. The Equipment was subject to the debt incurred by [REDACTED] in its purchase. By a purchase agreement dated [REDACTED], [REDACTED] sold the Equipment (together with other property leased to other third-party lessees¹) for a total of \$ [REDACTED]² to [REDACTED], a Delaware limited partnership composed in part of another partnership, [REDACTED] as limited partner. [REDACTED] assumed the financing debt of [REDACTED] and issued to [REDACTED] a secured recourse promissory note ("Note") in the amount of \$ [REDACTED]. [REDACTED] was required to pay [REDACTED] within [REDACTED] days with an [REDACTED]% interest charge.

¹ At this point in the transaction and for certain following steps, other groups of property were conveyed and leased together with the Equipment, but at a later date, these other groups of property were sold separately. As a result, documents representing the early steps in the transaction will refer to [REDACTED] schedules, while later documents will refer to only [REDACTED] schedules.

² An appraisal dated [REDACTED] and prepared by the appraisal firm of [REDACTED] concluded that as of that date, all the property conveyed had a fair market value of \$ [REDACTED]. The Equipment, separately valued, had a fair market value of \$ [REDACTED]. [REDACTED] were retained by [REDACTED], the general managing partner of which, as will be described in Step 2, is [REDACTED].

(The face amount of the [REDACTED] Note was paid on [REDACTED] as will be described in Step 9.) The [REDACTED] Note was secured by a lien on the Equipment and on the pre-existing user leases in favor of [REDACTED]. Financing statements were prepared and filed.

Step 2: By a purchase agreement also dated [REDACTED] [REDACTED] sold the Equipment (together with other property leased to other third-party lessees) for a total of \$ [REDACTED] to [REDACTED] a Nevada limited partnership composed in part of the tax-exempt [REDACTED] as [REDACTED]% limited partner and [REDACTED] as managing general partner. The Equipment and the pre-existing user leases remained subject to the financing debt of [REDACTED] and the lien in favor of [REDACTED] securing the [REDACTED] Note. [REDACTED] issued to [REDACTED] a secured recourse promissory note ("[REDACTED] Note") in the amount of \$ [REDACTED] requiring [REDACTED] to pay [REDACTED] within [REDACTED] days with an [REDACTED]% interest charge. The [REDACTED] was secured by a lien on the Equipment and on the pre-existing user leases in favor of [REDACTED].

Step 3: By a purchase agreement also dated [REDACTED] [REDACTED] sold the Equipment (together with other property leased to other third-party lessees) for a total of \$ [REDACTED] to [REDACTED]³ a Delaware corporation. [REDACTED] issued to [REDACTED] a secured nonrecourse installment note ("[REDACTED] Note") in the amount of \$ [REDACTED] (payable in [REDACTED] installments beginning on [REDACTED] and ending on [REDACTED] and a short-term secured recourse note ("[REDACTED] Short-Term Note") in the amount of \$ [REDACTED] due within [REDACTED] days with an [REDACTED]% interest charge. Both the [REDACTED] Note and the [REDACTED] Short-Term Note were secured by liens on the Equipment and on the pre-existing user leases in favor of [REDACTED].

Step 4: By an agreement of lease dated [REDACTED] ("Master Lease"), [REDACTED] leased the Equipment (together with other property leased to other third-party lessees) back from [REDACTED] thus transforming [REDACTED] from lessor to sublessor to the end users [REDACTED] and [REDACTED]. Rental payments to [REDACTED] under the Master Lease exactly equaled note payments to [REDACTED] under the [REDACTED] Note. The expiration dates under the Master Lease between [REDACTED] and [REDACTED] were [REDACTED] for the property leased by [REDACTED] and [REDACTED] for the property leased by [REDACTED] (We presume that the purpose of the Master Lease was to "sell" the deductions related to the Equipment to [REDACTED] while stripping the rental income from the pre-existing user leases and allocating it to the [REDACTED]).

Step 5: Also on [REDACTED] [REDACTED] the then-sublessor of the Equipment, executed a remarketing agreement with [REDACTED] under which [REDACTED] would "assist Sublessor in remarketing the equipment upon the expiration of the User Lease and in discharging

³ [REDACTED] is believed to be related to [REDACTED] a partner in [REDACTED] by virtue of a common officer, [REDACTED].

Sublessor's obligations under the Master Lease." [REDACTED] signed a consent to this transaction.

Step 6: Also on [REDACTED], [REDACTED] executed a remarketing agreement with [REDACTED] under which [REDACTED] would be responsible for remarketing the Equipment after the relevant expiration dates under the Master Lease, either [REDACTED] (property leased by [REDACTED]) or [REDACTED] (property leased by [REDACTED]).

To summarize steps 1 through 6, the Equipment was sold by [REDACTED] to [REDACTED] (for \$[REDACTED]), by [REDACTED] to [REDACTED] (for \$[REDACTED]), and finally by [REDACTED] to [REDACTED] (for \$[REDACTED]), with [REDACTED] then leasing the Equipment back from [REDACTED] all these steps taking place on [REDACTED]. [REDACTED] and [REDACTED] are paying offsetting amounts in rental payments and note payments. The pre-existing user leases involving the end users [REDACTED] and [REDACTED] continued in force and effect without interruption through these various steps, so that as of [REDACTED] under the terms of the Master Lease, [REDACTED] assumed the position of sublessor to these third-party lessees. (It should be noted here that the terms of the Master Lease effectively allow [REDACTED] the lessor, no possibility of making a profit from the Equipment until either [REDACTED] the expiration date of the leases with [REDACTED] or [REDACTED] the expiration date of the leases with [REDACTED].) The Equipment and the pre-existing user leases are subject to the financing debt of [REDACTED] the lien in favor of [REDACTED] securing the [REDACTED] Note, the lien in favor of [REDACTED] securing the [REDACTED] Note, the lien in favor of [REDACTED] securing the [REDACTED] Note and the [REDACTED] Short-Term Note, and two remarketing agreements with [REDACTED] one with [REDACTED] as sublessor, to cover the period after the relevant expiration dates of the pre-existing user leases and until the relevant expiration dates of the Master Lease, and the other with [REDACTED] as lessor, to cover the period after the relevant expiration dates of the Master Lease.

Step 7: On [REDACTED], [REDACTED] sold the "Initial Lessor Rights," those being the right to all rental income through the terms of the pre-existing user leases with [REDACTED] and [REDACTED] (together with the rental income from the other property leased to the other third-party lessees), for a total of \$[REDACTED] to [REDACTED], a Delaware corporation, thereby accelerating the rental income. The sale proceeds of \$[REDACTED] received from [REDACTED] were applied to the [REDACTED] Note, leaving a balance due to [REDACTED] of \$[REDACTED]. In conjunction with the sale of the Initial Lessor Rights, [REDACTED] (as holder of the [REDACTED] Note), [REDACTED] (as holder of [REDACTED] Note), and [REDACTED] (as holder of the [REDACTED] Note and the [REDACTED] Short-Term Note) agreed to release the liens in favor of each on the pre-existing user leases. [REDACTED] and [REDACTED] (but not [REDACTED]) agreed to subordinate the liens in favor of each on the Equipment to the rights of [REDACTED]. Once the right to rental income was sold to [REDACTED] the end users [REDACTED] and [REDACTED] (and the other third-party lessees) were instructed to pay rent directly to [REDACTED]. Further, as part of this arrangement, [REDACTED] satisfied the financing debt of [REDACTED] in part and assumed the remaining part.

Step 8: On [REDACTED] [REDACTED] sold the "residual rights" to property leased by [REDACTED] for the [REDACTED]-year period following the expiration of the pre-existing user leases for \$ [REDACTED] to [REDACTED], a Delaware corporation (later acquired by [REDACTED] from [REDACTED], [REDACTED]'s sole shareholder, who is also vice president of [REDACTED], thereby again accelerating rental income, except in this instance the rental income would only become available after the expiration of the terms of the pre-existing user leases with [REDACTED]. The sale proceeds of \$ [REDACTED] received from [REDACTED] were applied to the [REDACTED] Note, leaving a balance due to [REDACTED] of \$ [REDACTED].

To summarize steps 7 and 8, as of [REDACTED] the Equipment continued to be owned by [REDACTED]. [REDACTED] has sold the right to rental income under the pre-existing user leases to [REDACTED]. The interests of [REDACTED] ([REDACTED] Note), [REDACTED] ([REDACTED] Note), and [REDACTED] ([REDACTED] Note and [REDACTED] Short-Term Note) in the pre-existing user leases have been extinguished. The liens of [REDACTED] and [REDACTED] in the Equipment have been subordinated to the rights of [REDACTED]. [REDACTED] holds the remarketing rights for all the Equipment. [REDACTED] has satisfied or assumed the financing debt of [REDACTED]. Residual rents for the property leased by [REDACTED] have been sold to [REDACTED] for the [REDACTED]-year period following the expiration of those pre-existing user leases.

Step 9: On [REDACTED] as part of a purported section 351 transfer, [REDACTED] assigned its interest in the Master Lease and its interests in the [REDACTED] Note and in the [REDACTED] Short-Term Note to [REDACTED] (" [REDACTED] "), a New Hampshire corporation and a subsidiary of [REDACTED] (" [REDACTED] 's parent "), in exchange for [REDACTED] shares of preferred stock in [REDACTED]. Contemporaneously, [REDACTED]'s parent agreed to acquire [REDACTED] shares of common stock in [REDACTED] for \$ [REDACTED] in cash. Again, as through prior steps in the transaction, the pre-existing user leases involving the end users [REDACTED] and [REDACTED] continued in force and effect without interruption through the assignment of the Master Lease by [REDACTED] to [REDACTED] so that [REDACTED] then assumed the position of sublessor to these third-party lessees. [REDACTED] assumed [REDACTED]'s obligation to pay rent to [REDACTED] under the Master Lease and was assigned [REDACTED]'s right to note payments under the [REDACTED] Note, with the note payments exactly equaling the rental payments, as was the case with the arrangement described in Step 4. [REDACTED] acknowledged and agreed to the assignment. Notices were also sent to the third-party lessees, who acknowledged and agreed to the above transfer, but were directed by the notices to continue paying rent to [REDACTED].

To summarize step 9, as of [REDACTED] the owner of the Equipment continues to be [REDACTED], but now the sublessor is [REDACTED] under the Master Lease. [REDACTED] transferred the [REDACTED] Note and the [REDACTED] Short-Term Note along with the future rental obligations to [REDACTED] in a purported section 351 transfer. [REDACTED] by issuing [REDACTED] shares of preferred stock in [REDACTED] in the exchange, has acquired rental expenses. [REDACTED] and [REDACTED] are paying offsetting amounts in payments for rent and payments on the [REDACTED] Note. Further, [REDACTED] has been removed from the picture as a creditor with a lien on the Equipment, leaving the Equipment now subject to the interests of [REDACTED] as to the rental

income and the subordinated liens in favor of [REDACTED] securing the [REDACTED] Note and of [REDACTED] securing the [REDACTED] Note and the [REDACTED] Short-Term Note.

Step 10: By a purchase agreement dated [REDACTED] [REDACTED] sold the Equipment (together with other property leased to other third-party lessees) to [REDACTED] for \$[REDACTED] and the assumption of the [REDACTED] Note, the unpaid balance of which, as of [REDACTED] according to the purchase agreement, was \$[REDACTED] and also assigned its interest in the Master Lease to [REDACTED] thus making [REDACTED] now the lessor to [REDACTED] with regard to the Equipment (together with other property leased to other third-party lessees). [REDACTED] issued to [REDACTED] a secured promissory note in the original principal amount of \$[REDACTED] ("[REDACTED] Note")

Step 11: By another purchase agreement also dated [REDACTED] [REDACTED] in turn sold⁴ the Equipment⁵ for \$[REDACTED] to [REDACTED] a Delaware corporation, that interest being subject to the interest of [REDACTED] in the rental income, the lien in favor of [REDACTED] securing the [REDACTED] the lien in favor of [REDACTED] securing the [REDACTED] Note (now assumed by [REDACTED]), and the lien in favor of [REDACTED] securing the [REDACTED] Note. [REDACTED] assigned its interest in the Master Lease to [REDACTED] thus making [REDACTED] now the lessor to [REDACTED]. In exchange, [REDACTED] received a long-term nonrecourse secured installment promissory note ("[REDACTED] Long-Term Note")⁶ in the amount of \$[REDACTED] (payable in semi-annual installments beginning on [REDACTED] and ending on [REDACTED]) and a short-term secured promissory note ("[REDACTED] Short-Term Note") in the amount of \$[REDACTED]. [REDACTED] then entered into a lease agreement dated [REDACTED] ("Over Lease") with [REDACTED], which arrangement in fact amounted to a purchase by [REDACTED] of the right to rental payments due from [REDACTED] under the Master Lease. In this lease agreement, [REDACTED] committed to apply all such payments received to the satisfaction of the [REDACTED] Note, for which [REDACTED] apparently remained liable. The note payments due to [REDACTED] under the [REDACTED] Long-Term Note exactly equaled the rental payments due to

⁴ The language of the purchase agreement is careless in referring to each party as the "Seller," suggesting that it, like the other supposedly dispositive documents evidencing the steps in the transaction, was merely *pro forma* and not the result of arms' length negotiations or review by truly opposing counsel.

⁵ As was referred to in footnote 1, it was at this point that the Equipment was sold separately from the other property leased to other third-party lessees, and thus this purchase agreement only refers to five schedules, instead of eight schedules. We are unaware of what happened to the other property.

⁶ In response to IDR no. 22, the Taxpayer explained that even though it was obligated to do so under the [REDACTED] Long-Term Note, [REDACTED] did not prepare financing statements for filing, and apparently neither [REDACTED] nor [REDACTED] insisted on such performance, thus calling in question the bona fides of the arrangement.

██████████ under the Over Lease and were due on the exact same dates and for the exact same terms. The expiration dates under the Over Lease between ██████████ and ██████████ were ██████████ for the property leased by ██████████ and ██████████ for the property leased by ██████████.

Step 12: By a lease rental purchase agreement dated ██████████ ██████████ sold to ██████████, a Delaware corporation, the right to rental income under the Master Lease that it had purchased the day before through the Over Lease arrangement with ██████████. In exchange, ██████████ assumed the ██████████ Note, now in the amount of \$██████████. ██████████ also paid ██████████ \$██████████ to account for the difference between the discounted present value of the rental income and the discounted present value of the ██████████ Note.

Step 13: By the A & A Agreement dated ██████████ ██████████ assigned the ██████████ Long-Term Note to ██████████ in exchange for ██████████'s assumption of "certain of ██████████'s Obligations," which may⁷ include the ██████████ Note and the ██████████ Note, and for ██████████'s issuance of ██████████ shares of its common stock. Contemporaneously, the Taxpayer contributed \$██████████ to ██████████ in exchange for ██████████ shares of ██████████'s stock. According to the Taxpayer, this transfer together with ██████████'s contribution of the ██████████ Long-Term Note in exchange for the ten shares of ██████████'s common stock constituted a section 351 transfer, thus supposedly allowing ██████████ to calculate its basis in the note as \$██████████⁸ under section 362(a). Through the A & A Agreement, ██████████ became liable for so-called rental payments to ██████████ by ██████████'s assignment to ██████████ of its interest in the Over Lease (with the now-familiar routine of those rental payments exactly equaling the note payments⁹), even though ██████████ had previously sold the right to rental payments under the Master Lease to ██████████ as described in Step 12, which right appears to have been the only true property interest represented by the Over Lease.¹⁰ Nonetheless, the rental payments for this seemingly

⁷ The A & A Agreement is also somewhat careless in its language, in the same manner as the purchase agreement described in footnote 4.

⁸ The amount of \$██████████ is the amount recorded by the Taxpayer on its books for the value of the ██████████ Long-Term Note and includes the face amount of \$██████████ plus interest of \$██████████ for the month of ██████████.

⁹ According to a letter dated ██████████ and signed by the principals of both parties, ██████████ and ██████████ agreed to simply offset their respective liabilities, thereby obviating the need for actual money transfers.

¹⁰ The A & A Agreement is so dense in its dizzying incorporations-by-reference to previously designated bundles of rights, benefits, obligations, etc., arising from earlier transactions, that any attempt to sort out who receives what becomes a daunting task.

worthless right represent the claimed rental expenses of \$[REDACTED] for [REDACTED] and of \$[REDACTED] for [REDACTED] that the Service now proposes to disallow.

Step 14: On [REDACTED] [REDACTED] transferred to [REDACTED] a Delaware limited partnership, the [REDACTED]% partner of which is the [REDACTED] its interest in the [REDACTED] Long-Term Note to the extent of the pre-existing users leases with [REDACTED] (those being with regard to the [REDACTED] [REDACTED] in exchange for [REDACTED]'s assumption of the unpaid balance of the [REDACTED] Note in an amount not to exceed \$[REDACTED] and for its assumption of [REDACTED]'s obligation for rental payments to [REDACTED] under the Over Lease to the extent of these assets. On its return for [REDACTED] the Taxpayer characterized this partial disposition of the [REDACTED] Long-Term Note as constituting a rental expense of \$[REDACTED], the carryover of which expense, as noted earlier, the Taxpayer claimed as a net operating loss deduction of \$[REDACTED] for [REDACTED], which deduction the Service now proposes to disallow.

Step 15: On [REDACTED] [REDACTED] transferred to [REDACTED] a California corporation owned by [REDACTED] its interest in the [REDACTED] Long-Term Note to the extent of a [REDACTED]% interest in the pre-existing users leases with [REDACTED] (those being with regard to [REDACTED] of the [REDACTED] [REDACTED] in exchange for an unsecured promissory note with a face value of \$[REDACTED] and for [REDACTED]'s assumption of [REDACTED]'s obligation for rental payments to [REDACTED] under the Over Lease to the extent of these assets. On the basis of this transaction, the Taxpayer claimed a loss on this partial disposition of the [REDACTED] Long-Term Note on its Form 1120 for [REDACTED] in the amount of \$[REDACTED] which loss the Service now proposes to disallow, together with claimed rental expenses of \$[REDACTED] purportedly paid to [REDACTED]

Step 16: On [REDACTED] [REDACTED] transferred to [REDACTED] its interest in the [REDACTED] Long-Term Note to the extent of a [REDACTED]% interest in the pre-existing users leases with [REDACTED] (those being with regard to the last one of the [REDACTED] [REDACTED] in exchange for an unsecured promissory note with a face value of \$[REDACTED] and for [REDACTED]'s assumption of [REDACTED]'s obligation for rental payments to [REDACTED] under the Over Lease to the extent of this asset. On the basis of this transaction, the Taxpayer claimed a loss on this partial disposition of the [REDACTED] Long-Term Note in the amount of \$[REDACTED] which loss the Service now proposes to disallow, together with claimed rental expenses of \$[REDACTED] purportedly paid to [REDACTED]

Step 17: On [REDACTED] [REDACTED] redeemed the [REDACTED] shares of its stock issued to [REDACTED] in the purported section 351 transfer for \$[REDACTED] or \$[REDACTED] a share.

In responding to IDR no. 10 asking for the business purpose behind the transaction in which [REDACTED] received the [REDACTED] Long-Term Note in exchange for its assumption of liabilities and for the issuance of [REDACTED] shares of its common stock, the Taxpayer

stated: "[REDACTED]
[REDACTED]
[REDACTED]"

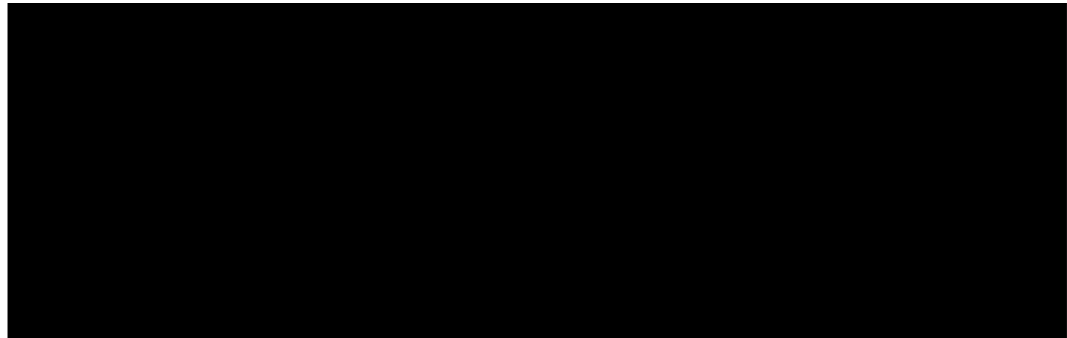
In responding to IDR no. 19 asking about sales literature, promotional material or other items used in arranging the transaction, the Taxpayer replied that no such items existed and that any financial analysis information had been previously discarded in a routine clean-up of old files. But the Taxpayer went on to insist, nonetheless, that a financial analysis had in fact been prepared, which analysis supported an "expectation of profit from the transaction." The Taxpayer then attached a schedule of expected residual rents prepared by the appraisal firm of [REDACTED] to show:

[REDACTED] had substantial economic motivation for investing in the leasehold interest. [REDACTED] paid \$[REDACTED] for the renewal rights [residual rents] to the [REDACTED] equipment schedules, in the anticipation of earning over \$[REDACTED] in renewal rent from these schedules. There was a risk that [REDACTED] would not receive the \$[REDACTED] in renewal rent. However, based on our knowledge and experience of the leasing industry and this type of equipment we concluded that the investment of \$[REDACTED] which we considered relatively small, with the potential to receive [REDACTED] times that amount was a good business opportunity.

The \$[REDACTED] refers to a payment made on [REDACTED] supposedly in satisfaction of the [REDACTED] Note assumed by [REDACTED] in the purported section 351 transfer described in Step 13, although an IDR in this regard is still outstanding.

Also in responding to IDR no. 10 asking as to the establishment of the value of the final interest in the [REDACTED] Long-Term Note as \$[REDACTED] the Taxpayer stated:

[REDACTED]



LAW AND ANALYSIS:

The losses and rental expenses as claimed by the Taxpayer are subject to challenge under three alternative theories. Under the first theory, the Service should argue that because the underlying transaction lacks economic substance, the claiming of the losses and rental expenses should not be respected for federal tax purposes. The second theory is somewhat related to the first in that it relies on the sham nature of the transaction to contend that no business purpose exists behind the Taxpayer's actions in the purported section 351 transfer. The third theory focuses on the obviously interlocking relationships of the parties involved to invoke section 482 and thereby reallocate the losses and rental expenses.

1. Economic Substance Test

An evaluation of whether a lease-stripping transaction lacked economic substance requires a review of separate, but interrelated, inquiries: (1) a subjective inquiry into whether the transaction was carried out for a valid business purpose; and (2) an inquiry into the objective economic effect of the transaction. *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), *aff'd in relevant part*, T.C. Memo. 1997-115, *cert. denied*, 526 U.S. 1017 (1999), 157 F.3d at 247-248; *Casebeer v. Commissioner*, 909 F.2d 1360 (9th Cir. 1990), *aff'd sub nom. Sturm v. Commissioner*, T.C. Memo. 1987-625, 909 F.2d at 1363; *Kirchman v. Commissioner*, 862 F.2d 1486, 1490-1491 (11th Cir. 1989).

To satisfy the business purpose inquiry, the transaction must be "rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and ... economic situation." *Compaq Computer Corp. v. Commissioner*, 113 T.C. 214, 224 (1999), quoting *ACM Partnership*, T.C. Memo. 1997-115, 73 T.C.M. (CCH) 2189, 2217, *aff'd in relevant part*, 157 F.3d 231 (3d Cir. 1998), *cert. denied*, 526 U.S. 1017 (1999); see *Kirchman*, 862 F.2d at 1490-1491.

To satisfy the objective economic inquiry, the transaction must appreciably affect the taxpayer's beneficial interest, absent tax benefits. *Knetsch v. United States*, 364 U.S. 361, 366 (1960); *ACM Partnership*, 157 F.3d at 248. Courts have recognized that offsetting legal obligations, or circular cash flows, may effectively eliminate any real economic significance of the transaction. *Knetsch v. United States*, 364 U.S. 361 (1960). Modest or inconsequential profits relative to substantial tax benefits are insufficient to imbue an otherwise questionable transaction with economic substance. *ACM Partnership*, 157 F.3d at 258; *Sheldon v. Commissioner*, 94 T.C. 738, 767-768 (1990); *Saba Partnership v. Commissioner*, T.C. Memo. 1999-359, 78 T.C.M. (CCH) 684, 721-722.

The overall transaction varies somewhat from the rudimentary lease-strip form as described, for example, in Notice 95-53 and in Coordinated Issue Paper, Lease Stripping Transactions, 2000 TNT 147-10, in that instead of just one tax-indifferent party to absorb income, there are two, [REDACTED] and [REDACTED] and instead of just one "buyer" of deductions related to the leased property, there are two, [REDACTED] and [REDACTED]. Further, there is an additional form of rental transaction, the Over Lease, which is actually a rental of rental payments. The first and garden-variety lease-strip in this case takes place at Steps 1, 2, 3, 7, and 8, in association with a sale-leaseback between [REDACTED] and [REDACTED] at Step 4, so that any depreciation and other deductions presumably may be claimed by the corporation buyer-lessor, [REDACTED] while the partnership seller-lessee, [REDACTED] can then sell the current and future rental streams and allocate such income to its tax-exempt partner, the [REDACTED].¹¹ At Step 10, another sale then occurs with [REDACTED] selling the leased property to a second partnership, [REDACTED] whose majority partner is a partnership, [REDACTED] whose majority partner in turn is, again, the [REDACTED]. On the same day as the sale to [REDACTED] yet another sale-leaseback occurs at Step 11 involving a second corporation buyer-lessor, this time [REDACTED] except that now the lease-back is not of property but of the right to rental payments arising from the prior sale-leaseback. [REDACTED] then accelerates that rental income by the sale to [REDACTED] in Step 12. Steps 11 and 12 constitute the second lease-strip in the overall transaction, but, as just noted, the income absorbed and accelerated is not the typical kind of rental income, being instead income from the rental of rental payments. At Step 13, [REDACTED] then engages in a purported section 351 transfer involving the Taxpayer and the Taxpayer's subsidiary [REDACTED] the main abuse of which for our purposes is the transfer of a high-basis, low-fair-market-value asset to the Taxpayer's subsidiary, which property in the subsequent open years underlies the claiming of losses without economic reality upon disposition of the property. This property was the [REDACTED] Long-Term Note with a basis recorded by [REDACTED] at \$[REDACTED] that [REDACTED] had received in payment for certain heavily encum-

¹¹ Somewhat tangential to our case but indicative of the taint with which the Equipment is imbued is how, at Step 9, [REDACTED] assigns its interests to [REDACTED] as part of an earlier purported section 351 transfer, the bona fides of which certainly appear in question.

bered and somewhat dated technical assets for which both the current and future rental streams had been sold, as well as any remarketing rights. The assets were presumably of value to [REDACTED] the maker of the note, only to the extent of any depreciation and other deductions.

The purported section 351 transfer lacks economic substance most particularly because on [REDACTED] all that [REDACTED] could look forward to as a return on its investment was becoming a foreclosing creditor upon the event of [REDACTED]'s default on the [REDACTED] Long-Term Note. In that case, [REDACTED] could conceivably exercise its self-help remedies under the Delaware incorporation of the Uniform Commercial Code and obtain title to the Equipment, subject of course to all existing encumbrances, including its own obligation under the Over Lease to pay rent to [REDACTED]. But even once it obtained title, [REDACTED] would have to wait [REDACTED] years with regard to the property leased by [REDACTED] and [REDACTED] years with regard to the property leased by [REDACTED] before it could expect any return on its investment.

Further, as a matter of *post hoc* evidence of lack of economic substance, we can look at the investment return on the disposition of the interests in the note receivable. On [REDACTED] less than [REDACTED] months after assignment of the [REDACTED] Long-Term Note, [REDACTED] disposed of its interest in the [REDACTED] Long-Term Note to the extent of the [REDACTED] as leased by [REDACTED] in exchange for [REDACTED]'s assumption of the unpaid balance of the [REDACTED] Note in an amount not to exceed \$[REDACTED]. The Taxpayer thereafter claimed a rental expense (mischaracterized) of \$[REDACTED] based on this disposition, the carryover of which expense was claimed as a net operating loss deduction of \$[REDACTED] for [REDACTED]. On [REDACTED] [REDACTED] disposed of its interest in the [REDACTED] Long-Term Note to the extent of the [REDACTED] and the [REDACTED] as leased by [REDACTED] in exchange for an *unsecured* promissory note in the amount of \$[REDACTED]. The Taxpayer thereafter claimed a loss of \$[REDACTED] for [REDACTED] on this disposition. On [REDACTED] [REDACTED] disposed of the remainder of its interest in the [REDACTED] Long-Term Note, that is, to the extent of the [REDACTED] as leased by [REDACTED] in exchange for yet another *unsecured* promissory note in the amount of \$[REDACTED]. And the Taxpayer thereafter claimed a loss of \$[REDACTED] for [REDACTED] on the disposition.

In responding to IDR no. 10, the Taxpayer explained the poor return on the final segment of the [REDACTED] Long-Term Note by describing what a poor remarketing agent [REDACTED] turned out to be, forcing [REDACTED] thereby to simply cut its losses by recognizing a loss of \$[REDACTED] for [REDACTED]. As to such a write-off for [REDACTED] we might grant the story some small credibility due to changing business conditions over time, but as we progress back in time to the write-off for [REDACTED] and then back further to the *de facto* write-off for [REDACTED] less than [REDACTED] months after assignment of the [REDACTED] Long-Term Note, the story loses credibility altogether. It seems quite strange that a company that

prides itself on being in the business of "acquiring, structuring and investing in leased assets" would become involved in such a dismal business position.¹²

Another aspect of the overall transaction that demonstrates a lack of economic substance is the Over Lease arrangement as described in Step 11. In order to acquire "an investment in leased assets efficiently and inexpensively," ██████ agreed not only to issue ██████ shares of its common stock to ██████ and to assume the ██████ Note but also to agree to assume ██████'s obligation to pay "rent" under the Over Lease, which deal was in fact an installment sale of the right to receive rental payments under the Master Lease with ██████ which right ██████ had sold to ██████ prior to the assignment to ██████. In other words, as far as ██████ was concerned, its lessee's interest under the Over Lease was to pay rent in return for nothing. The Taxpayer would undoubtedly respond that since the rental payments under the Over Lease and the note payments under the ██████ Long-Term Note exactly equaled each other and came due on the same dates (and did not even require actual money transfers as described in footnote 9), this arrangement was no detriment or hindrance, being as it was simply a "wash."¹³ But when seen in its bare essential parts, this step may be considered the most flagrant and bogus of all and certainly militates in favor of disallowing the claimed rental expenses as having no economic substance. At most, these payments may be added as an additional cost in acquiring the ██████ Long-Term Note once the purported section 351 transfer is disregarded, as discussed below, and the exchange is treated as taxable under section 1001.

2. Business Purpose Test

Section 351 requires a business purpose. *Caruth v. United States*, 688 F.Supp. 1129, 1140-41 (N.D. Tex. 1987). A transfer of property cannot be afforded nonrecognition treatment under section 351 when the taxpayer can show no valid business purpose for the transfer. *Stewart v. Commissioner*, 714 F.2d 977, 992 (9th Cir. 1983), *aff'g* T.C. Memo. 1982-209.

As noted earlier, in responding to IDR no. 10, the Taxpayer asserted that its business purpose behind the purported section 351 transfer was to acquire an interest in leased assets. But with the acquisition of the ██████ Long-Term Note, ██████

¹² And it should be noted that ██████ was retained as the remarketing agent by ██████ of which ██████ was the general managing partner.

¹³ As will be discussed with regard to the business purpose test, this arrangement may also be characterized as a circular cash flow.

became, at best, a creditor¹⁴ of [REDACTED] the true owner of the Equipment, and for even that true owner to obtain any significant return on its investment in the Equipment, it would have to wait [REDACTED] years with regard to the property leased by [REDACTED] and [REDACTED] years with regard to the property leased by [REDACTED]. Considering the high density of boilerplate in the documents, particularly the A & A Agreement, it is often difficult to determine exactly what right or obligation is held or owed by which party with regard to any other party. But it does appear reasonably clear, as of [REDACTED] despite any contrary obfuscation in the A & A Agreement, that we must accept [REDACTED] as the owner of the Equipment and that we must accept the Master Lease with [REDACTED] as being in effect through [REDACTED] (property leased by [REDACTED]) and through [REDACTED] (property leased by [REDACTED]). It is unclear what business purpose [REDACTED] could have had for its transaction with [REDACTED] as it is unclear how [REDACTED] could have achieved a profit independent of tax savings from the assets and liabilities that it received from [REDACTED]. Apparently the only purpose of the last steps of the transaction, then, was to transfer the [REDACTED] Long-Term Note through application of sections 351 and 362(a), effectively "selling" the built-in losses to [REDACTED] while allowing [REDACTED] to "buy" deductions related to the Equipment.

The Service and the various courts have distilled several factors that aid in determining whether a valid non-tax business purpose is present in a purported section 351 transfer. These factors include: (1) whether the transfer achieved its stated business purpose; (2) whether the transfer primarily benefitted the transferor or the transferee; (3) the amount of potential non-tax benefit to be realized by the parties; (4) whether the transferee corporation is a meaningless shell; (5) whether the transferee's existence is transitory; (6) whether the transferee corporation has any other assets of the type transferred; (7) the number of times the property was transferred, both prior to and after the section 351 transfer; (8) the amount of time each party held the property, both prior to and after the section 351 transaction, (9) whether there were any pre-arranged plans concerning future dispositions of the property; and (10) whether there were independent parties (such as creditors) that requested a specific structure for the transaction.

In reviewing these ten factors with a view to the facts of this case, we find that factors (1), (3), (7), and (8) are most relevant. Under factor (1), the transfer did not

¹⁴ At times, the Taxpayer appears to assume that it became the owner of the Equipment as a result of the purported section 351 transfer or, at least, became the owner of valuable rights with regard to the Equipment. For example, in responding to IDR no. 19, the Taxpayer stated that it "paid \$[REDACTED] for the renewal rights [residual rents] to the [REDACTED] equipment schedules, in the anticipation of earning over \$[REDACTED] in renewal rent from these schedules." Our review of the supposedly dispositive documents, however, finds that the Taxpayer was only a creditor of [REDACTED] the true owner of the Equipment.

meet the stated business purpose of investing in leased assets because [REDACTED] only became a creditor of another business that had invested, albeit somewhat detachedly, in leased assets. Further, even assuming that the income stream from the [REDACTED] Long-Term Note was seen as a "good" return on investment, as was noted in Step 13 and in footnote 9, the note payments were exactly offset by rental payments due under the bizarre Over Lease arrangement, therefore amounting to a circular cash flow that deprived that income stream of any value, and which kind of circular cash flow commonly appears in tax shelter situations, see, e.g., *ACM Partnership v. Commissioner*, 157 F.3d 231, 250 (3d Cir. 1998); *Sheldon v. Commissioner*, 94 T.C. 738, 769 (1990).

Under factor (3), even the amount of non-tax benefit to be reasonably anticipated by [REDACTED]'s debtor (or conceivably [REDACTED] upon its debtor's default) will arise only far in the future and therefore should be discounted significantly, especially in view of the age of the leased property.¹⁵ In the appraisal prepared by [REDACTED], the final rental payments for the property leased by [REDACTED] are listed as coming due on [REDACTED] and as totaling \$ [REDACTED]. But we must recall that the assignment to [REDACTED] the relevant business event, occurred on [REDACTED] meaning that the Taxpayer's management would probably have had to make the crucial business decision even sometime before that date. And we must recall further that the Master Lease as to the property leased by [REDACTED] would not expire until [REDACTED] and these would be technical assets of some sophistication, having been in operation since [REDACTED]. Greater doubts arise as to the property leased by [REDACTED]. In the appraisal, the final rental payments are listed as coming due on [REDACTED] and as totaling \$ [REDACTED] and, again, these would be technical assets, this time having been in operation since [REDACTED].

And under factors (7) and (8), the facts show that the Equipment and the various associated rights were conveyed, reconveyed, and conveyed yet again within severely collapsed time frames and with little attention to what would make any normal business sense. And again the mechanics of the Over Lease need to be outlined: The title to the Equipment passed to [REDACTED] along with the assignment of [REDACTED]'s interest in the Master Lease (meaning [REDACTED]'s right to receive rental payments from [REDACTED] the lessee under the Master Lease). But then [REDACTED], through the device of the Over Lease, "leases back" those same rental payments, thereby incurring rental payments in order to receive rental payments. From [REDACTED]'s perspective, such an arrangement may possess some business purpose as [REDACTED] promptly sells that rental stream to [REDACTED]. But then

¹⁵ With regard to the shelf life of the Equipment, a sentence in the Taxpayer's response to IDR no. 10 is instructive: "[REDACTED] Yet within the [REDACTED]-year period before that business judgment, a note receivable secured by such property was valued at more than \$ [REDACTED]"

why does [REDACTED] as part of the purported section 351 transfer, agree to take part in such convoluted set-up? The Taxpayer would probably explain it had to assume another's obligation, strange as it is, in order to clinch the deal of obtaining some hope of return on the residual rents. At some point, however, a certain simplicity or cleanliness in business affairs should be observed. See, e.g., *Beck v. Commissioner*, 85 T.C. 557, 579-80 (1985) ("Such [tax] incentives [for equipment leasing] are not intended, however, to create a new economy consisting of paper transactions having no relationship to the real value of goods and services."). And finally, the comments of footnotes 4, 6, and 7 as to lack of care in the observance of business trappings are also relevant in applying these two factors.

3. Section 482

Under section 482, the Service may allocate income or deductions between entities owned or controlled by the same interests in order to prevent the evasion of taxes or clearly to reflect income. The regulations under section 482 define control to include "any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised." Treas. Reg. § 1.482-1(i)(4); T.D. 8552, 1994-2 C.B. 93, 105. The regulations also state that "[i]t is the reality of control that is decisive," rather than a rigid focus on record ownership of the entities at issue. *Id.*; accord *Ach v. Commissioner*, 42 T.C. 114, 125 (1964), *aff'd*, 358 F.2d 342 (6th Cir. 1966); *Charles Town, Inc. v. Commissioner*, 372 F.2d 415, 419-20 (4th Cir. 1967), *aff'g* T.C. Memo. 1966-15. A presumption of control arises if income or deductions have been arbitrarily shifted, as a result of the actions of two or more persons acting in concert with a common goal or purpose. Treas. Reg. § 1.482-1(i)(4).

In determining whether income and deductions have been arbitrarily shifted and whether different persons were acting in concert pursuant to a common goal, the following nonexclusive factors should be considered: (1) whether the lease-stripping transaction was a registered tax shelter; (2) whether the parties to the lease-stripping transaction acted pursuant to a common plan that was designed to provide certain tax benefits to the taxpayer; (3) whether the individual steps that constitute the entire lease-stripping transaction make little economic and business sense from the perspective of a "hard-headed" business person; (4) the tax and non-tax benefits that each party to the lease-stripping transaction stood to gain by engaging in the transaction, including whether a participant's benefits were merely compensation for performing its pre-designed role; (5) the ability of an entity to perform its obligations under the lease arrangements with its own employees; and (6) an absence of any business activity by one of the parties to the lease-stripping transaction, other than the lease-stripping transaction at issue.

In reviewing these six factors with a view to the facts of this case, we find that factors (2), (3), and (4) are most relevant to the facts at hand. Under factor (2), the parties participated in not just one lease-stripping transaction but two, both involving the

██████████ as an eventual recipient of the stripped rental income and various outside "buyers" of deductions, with the resulting product to the Taxpayer being an inflated-basis note receivable from which a loss could be recognized.

Under factor (3), the lengthy wait until any investment return can be expected that was discussed above under the business purpose test applies here as well in gauging the transaction from the perspective of a "hard-headed" business person, as does the oddity of the Over Lease arrangement discussed above under the economic substance and business purpose tests.

And under factor (4), the participation of the ██████████ at three different steps in the transaction leads us inevitably to the conclusion that it is present solely as an accommodation party. See, e.g., ██████████
██████████

Once control is established by demonstrating that there was a common plan to arbitrarily shift income and deductions, it must be determined whether the control was exercised by the same interests. Although the phrase "same interests" is not defined in the regulations under section 482, case law as well as the legislative history of section 482 provide guidance. The phrase "same interests" includes different persons with a common plan to shift income and deductions. *Brittingham v. Commissioner*, 598 F.2d 1375, 1379 (5th Cir. 1979). Thus, central to the demonstration of "control" by the "same interests" is the establishment of a common design to shift income and deductions. See *Hall v. Commissioner*, 32 T.C. 390, 409-10 (1959).

As noted above, ██████████ is the general managing partner of ██████████ the ██████████% partner of which is the ██████████. The first lease-stripping transaction allowed the rental income to be allocated to that tax-indifferent party. The rental income was accelerated, and the deductions related to the leased property "sold" until the leased property ended up in the hands of another tax-indifferent party (but also involving the ██████████), which assigned an inflated-basis note receivable to ██████████ which less than ██████████ months later assigned a segment of the note to yet another tax-indifferent party (also involving the ██████████). And along the way, several of the steps are facilitated not with actual payments but with note payments conveniently equaling rental payments and conveniently coming due on the same dates. ██████████'s involvement in different steps of the transaction, together with close adherence to the standard-form lease-stripping techniques strongly compels a finding of a common plan by different parties to arbitrarily shift income and deductions.

Once control by the same interests is established, section 482 may be applied to nonrecognition transfers where property was contributed for tax-avoidance purposes. For example, section 482 may allocate income and deductions arising from an entity's disposition of built-in-loss property, which it acquired in a nonrecognition transfer, to the party that contributed it in the transaction. See Treas. Reg. § 1.482-1(f)(1)(iii). In lease-

stripping transactions, this analysis may apply by likening the contribution of property (in a purported section 351 transfer) after the income has been stripped off to a contribution of built-in-loss property. In this case, the assignment of the [REDACTED] Long-Term Note to [REDACTED] is in substance a contribution of built-in loss property by [REDACTED] to [REDACTED], and the Service could allocate the losses to [REDACTED].

4. Accuracy-Related Penalty

Section 6662(a) imposes an accuracy-related penalty in an amount equal to 20 percent of the portion of an underpayment attributable to, among other things: (1) negligence or disregard of rules or regulations, (2) any substantial understatement of income tax, and (3) any substantial valuation misstatement. There can be, however, no "stacking" of those components of the accuracy-related penalty. Treas. Reg. § 1.6662-2(c). Thus, the maximum accuracy-related penalty imposed on any portion of an underpayment is 20 percent (40 percent in the case of a gross valuation misstatement, I.R.C. § 6662(h)), even if that portion of the underpayment is attributable to more than one type of misconduct (e.g., negligence and substantial valuation misstatement). See *DHL Corp. v. Commissioner*, T.C. Memo. 1998-461 (the Service alternatively determined that either the 40-percent gross valuation misstatement penalty under section 6662(h) or the 20-percent negligence penalty under section 6662(b) was applicable).

Negligence includes any failure to make a reasonable attempt to comply with the provisions of the Internal Revenue Code or to exercise ordinary and reasonable care in preparing a tax return. See I.R.C. § 6662(c); Treas. Reg. § 1.6662-3(b)(1). Negligence also includes the failure to do what a reasonable and ordinarily prudent person would do under the same circumstances. See *Marcello v. Commissioner*, 380 F.2d 499 (5th Cir. 1967), *aff'd* 43 T.C. 168 (1964). Negligence is strongly indicated where a taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit, or exclusion on a return that would seem to a reasonable and prudent person to be "too good to be true" under the circumstances. Treas. Reg. § 1.6662-3(b)(1)(ii).

In this case, the Taxpayer's subsidiary issued [REDACTED] shares of its common stock, which were redeemed less than [REDACTED] years later for \$[REDACTED] and assumed an obligation that it subsequently satisfied for \$[REDACTED] in exchange for a note receivable that the Taxpayer recorded on its books at \$[REDACTED] (It also assumed an obligation to pay the so-called rent under the Over Lease, but these payments were exactly offset by the payments received under the note receivable, and did not even require actual money transfers.) The Taxpayer claims that a good business deal was made in paying \$[REDACTED] in anticipation of receiving over \$[REDACTED] in residual rents. But as has been discussed previously, the Taxpayer's subsidiary was only a creditor of the true owner of the Equipment, and consequently its interest was quite detached and derivative. The actual deal that was entered into was that of acquiring a high-basis, low-fair-market-value asset as to which losses could be claimed on disposition, while also deducting

rental payments under the Over Lease that were of no other benefit as also discussed previously. As a result, this was a deal too good to be true.

The phrase "disregard of rules and regulations" includes any careless, reckless, or intentional disregard of rules and regulations. The term "rules and regulations" includes the provisions of the Internal Revenue Code and revenue rulings or notices issued by the Internal Revenue Service and published in the Internal Revenue Bulletin. Treas. Reg. § 1.6662-3(b)(2). Therefore, if the facts indicate that a taxpayer took a return position contrary to any published notice or revenue ruling, the taxpayer may be subject to the accuracy-related penalty for an underpayment attributable to disregard of rules and regulations, if the return position was taken subsequent to the issuance of notice or revenue ruling.

Notice 95-53 was issued on [REDACTED] and therefore before the filing of the return for [REDACTED] on [REDACTED]. As a result, the Taxpayer should be held liable for the penalty as it was on notice as to the impropriety of taking advantage of such transactions. And for purposes of this penalty, the participation of [REDACTED] as the managing general partner of [REDACTED] which apparently arranged the first lease-strip in the transaction, is certainly relevant.

A substantial understatement of income tax exists for a taxable year if the amount of understatement exceeds the greater of 10 percent of the tax required to be shown on the return or \$10,000 in the case of corporations other than S corporations or personal holding companies. I.R.C. § 6662(d)(1). The assigned revenue agent has indicated that the adjustments based on the disallowances of the losses and rental expenses in question meet these technical thresholds.

If a corporate taxpayer has a substantial understatement that is attributable to a tax shelter item, see I.R.C. § 6662(d)(2)(C)(iii), the accuracy-related penalty applies to the understatement unless the reasonable cause exception applies. See Treas. Reg. § 1.6664-4(e). The determination of whether a corporation acted with reasonable cause and good faith is based on all pertinent facts and circumstances. Treas. Reg. § 1.6664-4(e)(1). A corporation's legal justification may be taken into account, as appropriate, in establishing that the corporation acted with reasonable cause and in good faith in its treatment of a tax shelter item, but only if there is substantial authority within the meaning of Treas. Reg. § 1.6662-4(d) for the treatment of the item and the corporation reasonably believed, when the return was filed, that such treatment was more likely than not the proper treatment.¹⁶ Treas. Reg. § 1.6664-4(e)(2)(i). Based on

¹⁶ The regulations provide that in meeting the requirement of reasonably believing that the treatment of the tax shelter item was more likely than not the proper treatment, the corporation may reasonably rely in good faith on the opinion of a professional tax advisor if the opinion is based on the tax advisor's analysis of the

all the above-described facts, we find the existence of neither substantial authority nor reasonable belief in the "more likely than not" standard.

In the unlikely event that the Taxpayer meets the "substantial authority" and "belief" requirements, that is still not dispositive if the taxpayer's participation in the tax shelter lacked significant business purpose or if the taxpayer claimed benefits that were unreasonable in comparison to the initial investment in the tax shelter. Treas. Reg. § 1.6664-4(e)(3). As noted above, the Taxpayer's participation does lack business purpose and it is a deal too good to be true.

For the accuracy-related penalty attributable to a substantial valuation misstatement to apply, the portion of the underpayment attributable to a substantial valuation misstatement must exceed \$10,000 in the case of a corporation other than an S corporation or a personal holding company. A substantial valuation misstatement exists if the value or adjusted basis of any property claimed on a return is 200 percent or more of the amount determined to be the correct amount of such value or adjusted basis. I.R.C. § 6662(e)(1)(A). If the value or adjusted basis of any property claimed on a return is 400 percent or more of the amount determined to be the correct amount of such value or adjusted basis, the valuation misstatement constitutes a "gross valuation misstatement." I.R.C. § 6662(h)(2)(A). If there is a gross valuation misstatement, the 20 percent penalty under section 6662(a) is increased to 40 percent. I.R.C. § 6662(h)(1). One of the circumstances in which a valuation misstatement may exist is when a taxpayer's claimed basis is disallowed for lack of economic substance. *Gilman v. Commissioner*, 933 F.2d 143, 150-52 (2d Cir. 1991), *cert. denied*, 502 U.S. 1031 (1992). If the facts establish that the adjusted basis of an asset with a basis traceable to a lease-stripping transaction is 200 percent or more of the correct amount, then either a substantial valuation misstatement or a gross valuation misstatement may exist.

Assuming that the purported section 351 transfer is disregarded, [REDACTED] will have to calculate its basis in the [REDACTED] Short-Term Note under section 1012, which will be \$ [REDACTED]. In that case and based on the Taxpayer recordation of the note at \$ [REDACTED] the valuation misstatement will be over 400 percent.

pertinent facts and authorities in the manner described in Treas. Reg. § 1.6662-4(d)(3)(ii) and the opinion unambiguously states that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Service. Treas. Reg. § 1.6664-4(e)(2)(i)(B)(2). Therefore, if possible, the tax advisor's opinion should be obtained to determine whether these requirements are met. We are not aware that the Taxpayer utilized a tax advisor to arrange the transaction. As suggested in footnote 4, no legitimate counsel may have even been involved. Instead, only employees of a tax-shelter mill may be providing the boilerplate documents.

In summary as to the accuracy-related penalty, it should be asserted at the 40 percent rate for gross valuation misstatement as to the losses and rental expenses on the three alternative grounds of lack of economic substance, failure to meet the business-purpose test, and reallocation under section 482.

If you have any questions, please call me at (619) 557-6014.

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JAMES W. CLARK
Area Counsel
(Communications, Technology, and Media:
Oakland)

(Signed) Gordon L. Gidlund
By: _____
GORDON L. GIDLUND
Associate Area Counsel
(Communications, Technology, and Media:
San Diego)

attachments: A & A Agreement
Excel charts
Visio charts (2) with notes

cc: Halvor Adams